

96-922-TP-UNC

-2-

originally proposed by Ameritech by 20 percent, the Commission predominately adopted the Ameritech recommendation for treatment of shared costs which relies upon unsupported demand forecasts. The Commission's ruling is, according to AT&T and MCI, against the weight of the evidence presented at the hearing.

- (5) Rehearing on this issue is denied. The Commission fully considered the evidence of record in making the clarification of shared costs set forth in our September 18, 1997 Entry on Rehearing. We have consistently noted that Ameritech's proposed methodology for allocating shared costs was a reasonable starting point; however, we also share the concerns raised by the intervenors (including AT&T and MCI) with particular inputs into the shared cost calculation. In fact, we specifically pointed to the insufficient evidence in the record supporting Ameritech's demand forecasts as one of the justifications for reducing the pool of recoverable shared costs by 20 percent. Therefore, contrary to the position expressed by AT&T and MCI, we did consider the lack of evidence supporting the demand forecasts when reaching a decision on the issue of shared costs.

It was also not unreasonable for us to acknowledge in the September 18, 1997 Entry on Rehearing that adopting AT&T and MCI's position on shared costs recovery (namely, that the 20 percent reduction should have been made to the percentage mark-up which resulted from the application of the shared costs to the extended TELRICs proposed by Ameritech) would amount to a double reduction in the amount of recoverable shared costs. It is undisputed by AT&T and MCI that the overall effect of the Commission's June 19, 1997 Opinion and Order as modified on rehearing actually reduced the TELRIC prices proposed by Ameritech. Thus, it is clear that inserting the lower TELRIC prices into a shared cost calculation multiplied by a percentage mark-up reduced by 20 percent (as proposed by AT&T and MCI) would result in an unjustified additional reduction in Ameritech's recoverable joint costs. On the other hand, permitting Ameritech to recover the entire pool of joint costs (as reduced by 20 percent to reflect the legitimate concerns expressed by the intervenors regarding the lack of evidence supporting particular items proposed to be recovered) does not result in an unjustified additional reduction in Ameritech's recoverable joint costs. For these reasons,

96-922-TP-UNC

-3-

the joint application for rehearing submitted by AT&T and MCI must be denied.

- (6) Ameritech argues in its application for rehearing that the Eighth Circuit Court of Appeals (Eighth Circuit), in a Order on Rehearing issued October 14, 1997, conclusively determined that Section 251(c)(3) of the 1996 Act does not obligate an incumbent local exchange carrier (ILEC), such as Ameritech, to permit a competitive local service provider to purchase an assembled platform of combined elements in order to offer competitive telecommunications services.³ Rather, Ameritech avers, the Eighth Circuit was clear that an ILEC must provide access to the network elements only on an unbundled (as opposed to a combined) basis. Consequently, Ameritech maintains that the September 18, 1997 Entry on Rehearing must be modified in two respects. Namely, the Commission should eliminate Ameritech's obligation to perform cost studies for combinations of two or more unbundled network elements. Also, the Commission should cancel the further proceedings intended to investigate whether or to what extent Ameritech must provide "common transport" as requested by a number of competitive local service providers.
- (7) Ameritech's application for rehearing concerning certain unbundled network combinations it agreed to provide to AT&T and MCI in their respective interconnection agreements as well as the cancellation of further proceedings on the issue of shared/common transport is denied.

Regarding combinations, the Commission found that the obligation to conduct and produce cost studies regarding certain network element combinations, agreed to by Ameritech as part of an arm's length negotiation with AT&T and MCI and incorporated into the parties' respective interconnection arrangements, was valid and enforceable.⁴ The Eighth Circuit's Order on Rehearing notwithstanding, Ameritech's agreement, through the give and take of an arm's length negotiation process, establishes an independent basis upon which to enforce the terms of the interconnection arrangements, as negotiated, and to require the company to provide TELRIC studies for certain unbundled network combinations. In so doing, we are enforcing the terms of the

³ *Iowa Utilities Board v. FCC*, Nos. 96-3321, et al., Order on Petitions for Rehearing (October 14, 1997).

⁴ The Commission approved AT&T's interconnection agreement in Case No. 96-752-TP-ARB and MCI's in Case No. 96-888-TP-ARB on February 20, 1997, and May 22, 1997, respectively.

interconnection arrangement to which Ameritech agreed. In making this decision, we affirm our previous position that we are not passing judgment on the manner in which Ameritech proposes to price the network element combinations it agreed to provide as part of the interconnection agreements. Rather, without an actual cost study, with supporting documentation, we have no way of knowing whether the prices Ameritech proposes to charge AT&T and MCI for unbundled network element combinations are reasonable. It should also be noted that the Eighth Circuit's October 14, 1997 Order on Rehearing is not at all clear regarding state decision-making. The decision centered on the FCC's authority under federal law relative to the states and did not address state action under federal law or state action under state law. We need not reach this issue at this time since our local guidelines, for the present, appear to be generally similar to the Eighth Circuit's decision on combinations. We will continue to examine this issue in the future as it is presented to us.

Ameritech's request for a cancellation of the further proceeding to investigate the issue of shared/common transport is likewise denied. As noted in the ~~September 18~~, 1997 Entry on Rehearing, the issue of shared/common transport is highly complex and has engendered significant debate. Conflicting decisions being rendered by the Federal Communications Commission (FCC) and the Eighth Circuit Court of Appeals further complicates this matter. It is clear, however, that the FCC, when faced with a similar argument as that made to this Commission by Ameritech, rejected Ameritech's contention and found shared transport to be an unbundled network element.⁵ Thus, at a minimum, Ameritech must submit for our review and approval a TELRIC study on the unbundled network element of shared transport as defined by the FCC. The Eighth Circuit's October 14, 1997 Order on Rehearing, which further clarified the issue of combinations, only reinforces our earlier determination that shared/common transport be subject to a further inquiry designed to sort out precisely what Ameritech's obligations are on the issue. For all the foregoing reasons, Ameritech's October 20, 1997 application for rehearing is denied.

⁵ Ameritech distinguishes "common transport" from "shared transport". The former, according to Ameritech, represents basic network connectivity and, as such, is a transport service as compared to shared transport which is a network element. Common transport is, Ameritech maintains, thus inextricably intertwined with switching.

It is, therefore,

ORDERED, That the applications for rehearing timely filed by Ameritech and jointly by AT&T and MCI are denied as set forth in Findings (5) and (7). It is, further,

ORDERED, That copies of this Entry on Rehearing be served upon all parties of record, their counsel, and any other interested person of record.

THE PUBLIC UTILITIES COMMISSION OF OHIO

Craig A. Glazer, Chairman

Jolynn Barry Butler

Ronda Hartman Fergus

David W. Johnson

Judith A. Jones

JRJ:geb

Entered In The Journal
November 6, 1997

Gary E. Vigorito
Secretary

BEFORE

THE PUBLIC UTILITIES COMMISSION OF OHIO

In the Matter of the Review of Ameritech)
Ohio's Economic Costs for Interconnection,)
Unbundled Network Elements, and Re-) Case No. 96-922-TP-UNC
ciprocal Compensation for Transport and)
Termination of Local Telecommunications)
Traffic.)

ENTRY

The Commission finds:

- (1) On June 19, 1997, the Commission issued an Opinion and Order, as modified and clarified in Entries on Rehearing issued September 18, 1997 and November 6, 1997, addressing in detail the total element long run incremental cost (TELRIC) studies submitted by Ameritech Ohio (Ameritech) in this matter. These TELRIC studies were developed to establish the rates for unbundled network elements which Ameritech proposes to charge competitors for provisioning unbundled network elements as required by the Telecommunications Act of 1996 and this Commission's local service guidelines set forth in Case No. 95-845-TP-COI.
- (2) As required by the Commission's September 18, 1997 Entry on Rehearing, Ameritech, on October 31, 1997, submitted another version of its TELRIC studies to the Staff and the parties that signed confidentiality agreements with the company in this proceeding. Staff has been meeting with the parties to determine whether the requirements of the June 19, 1997 Opinion and Order and the subsequent Entries on Rehearing have been followed. The Staff's review of the TELRIC studies submitted on October 31, 1997, is expected to conclude shortly.
- (3) At this time, the Commission deems it appropriate to commence a second phase of this proceeding. During this second phase, Ameritech is directed to develop TELRIC studies covering issues emanating from the past arbitration proceedings and to submit those studies for Commission review and approval. Those issues on which Ameritech is directed to develop TELRIC studies include compliance inspections, dial tone tests, unbundled dark fiber, manual interfaces, and the unbundled network element of shared interoffice transmission facilities (also known as shared transport) as defined by

the Federal Communications Commission in its Third Order on Reconsideration, CC Docket 96-98, released August 18, 1997. This shared interoffice transport extends to all of Ameritech's interoffice transport facilities and not just to interoffice facilities between an end office and tandem. Thus, Ameritech is required to provide shared interoffice transport between Ameritech end offices, between Ameritech tandems, and between Ameritech tandems and end offices. Ameritech is not, however, required to provide shared transport between its switches or serving wire centers and requesting carriers' switches. Nor is Ameritech required to provide shared transport between its switches and its serving wire centers.

In addition to the five TELRIC studies identified above, Ameritech is directed to develop and submit for Commission consideration, TELRIC studies governing the network element combinations that Ameritech voluntarily agreed to provide in the AT&T Communications of Ohio, Inc. (Case No. 96-752-TP-ARB) and MCI Telecommunications Corporation (Case No. 96-888-TP-ARB) arbitrations. As a final matter, we note that Ameritech has been directed to develop and submit for Commission approval, guidelines which will provide requesting carriers with a clear indication of the circumstances under which non-recurring charges will be applied so that these carriers can make informed decisions regarding which services and unbundled components to request from Ameritech.

- (4) Ameritech is directed to develop the TELRIC studies and the non-recurring charge guidelines identified in Finding (3) and to file such with the Commission and with the parties entering into confidentiality agreements with the company by April 30, 1998. Staff is directed to work with the parties to identify a procedure whereby these additional studies are subject to the appropriate regulatory scrutiny.

It is, therefore,

ORDERED, That Ameritech comply with Finding (4). It is, further,

ORDERED, That a copy of this Entry be served upon all parties of record.

THE PUBLIC UTILITIES COMMISSION OF OHIO

Craig A. Glazer, Chairman

Jolynn Barry Butler
Jolynn Barry Butler

Ronda Hartman Fergus
Ronda Hartman Fergus

Judith A. Jones
Judith A. Jones

Donald L. Mason
Donald L. Mason

JRJ/vrh

Entered in the Journal

MAR 19 1998

True Copy

Gary E. Vigorito

Gary E. Vigorito
Secretary

STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

Illinois Commerce Commission
On Its Own Motion

Investigation into forward looking cost
studies and rates of Ameritech Illinois for inter-
connection, network elements, transport and
termination of traffic.

96-0486

Consolidated

Illinois Bell Telephone Company

Proposed rates, terms and conditions for
unbundled network elements.

96-0569

SECOND INTERIM ORDER

PP 100-157

February 17, 1998

Post-It Fax Note	7671	Date	# of pages
To	Sub. Argentina	From	N. Wells
Co./Dept.		Co.	
Phone #		Phone #	
Fax #		Fax #	

I. INTRODUCTION	1
II. CONTESTED ISSUES	5
A. Relationship Between Wholesale and UNE Rates	5
B. Cost Study Assumptions	8
1. Cost of Capital	8
Position of AT&T/MCI	9
Position of Staff	10
2. Depreciation	22
3. Fill Factors	29
C. Shared and Common Costs	35
D. Non-Volume Sensitive Costs	54
E. Local Switching Prices	56
F. Call Termination Charges	60
G. Poles and Conduit	60
H. Recovery of "Residual"	61
I. Sum Of The Parts	73
J. Alternative Regulation	80
K. Nonrecurring Charges	85
L. Collocation	90
M. Power Consumption Charge	98
N. Common Transport	100
O. OS/DA Customized Routing	107
III. UNBUNDLED LOCAL SWITCHING	109
A. Access Charges	109
B. Usage Development and Implementation	115
C. Port Charges	120
D. Switch Feature Request Process	121
E. Centrex Charge	122
F. Bundling of UNEs	123
G. 800 Calls and the ULS Platform	126
H. Service Quality	126
I. Maintenance Issues	128
J. Structure Access Tariff Issues	128
K. Interim Number Portability	131
L. Directory Listings	132
M. Access To AIN Triggers	132
Intervenor Position	132
N. Limitations of Liability	133
O. Additional Proceedings	134
IV. FINDING AND ORDERING PARAGRAPHS	135

STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

Illinois Commerce Commission
On Its Own Motion

**Investigation into forward looking cost
studies and rates of Ameritech Illinois for inter-
connection, network elements, transport and
termination of traffic.**

96-0486

Consolidated

Illinois Bell Telephone Company

**Proposed rates, terms and conditions for
unbundled network elements.**

96-0589

SECOND INTERIM ORDER

By the Commission:

I. INTRODUCTION

On August 21 and 23, 1996, respectively, Teleport Communications Group, Inc. ("TCG") and AT&T Communications of Illinois, Inc. ("AT&T") filed motions to sever, from then-pending arbitrations under Section 252 of the federal Telecommunications Act of 1996 ("Act") between Ameritech Illinois, on the one hand, and AT&T and MCI Metro Access Transmission Services, Inc. ("MCI"), on the other, the issue of what prices should be established, under Sections 252(d)(1) and 252 (d)(2) of the Act, for Ameritech Illinois' provision of interconnection, unbundled network elements ("UNEs") and transport and termination of local traffic pursuant to the interconnection agreements that were the subject of those arbitrations. On September 9 and 10, 1996, respectively, Sprint Communications, L.P. ("Sprint") and AT&T filed petitions to open separate proceedings to address those pricing issues. In response to these petitions and motions to sever, on September 25, 1996, the Commission entered an order initiating Docket 96-0486 to investigate Ameritech Illinois' forward looking cost studies and establish Section 252(d) prices for Ameritech Illinois' provision of interconnection, UNEs and local transport and termination under its interconnection agreements. In initiating Docket 96-0486, we contemplated that the prices that we adopted in the docket would be incorporated subsequently into Ameritech Illinois' interconnection agreements through amendments to those agreements.

On September 27, 1996, Ameritech Illinois filed tariffs to establish prices and other terms and conditions for interconnection, UNEs and local transport and termination that would be available for purchase by all local carriers (including those not party to an interconnection agreement with Ameritech Illinois). These tariffs also revised the prices of Ameritech Illinois' existing UNE tariff offerings to comply with regulations that the Federal Communications Commission ("FCC") promulgated on August 8, 1996 in CC Docket No. 96-98 to implement Sections 251 and 252 of the Act. The FCC described and discussed those regulations in detail in its FCC Order in CC Docket No. 96-98 ("FCC Order"). On November 7, 1996, we suspended Ameritech Illinois' September 27 tariff filing and initiated Docket 96-0569 to investigate that filing.

Pursuant to notice, prehearing conferences were held in Docket 96-0486 before a duly authorized Hearing Examiner of the Commission at its Chicago offices on October 11 and 15, 1996. The following parties petitioned for and were granted leave to intervene by the Hearing Examiner: AT&T; A.R.C. Networks, Inc.; the Illinois Independent Telephone Association ("IITA"); SBMS Illinois Services, Inc. ("SBMS"); Consolidated Communications, Inc. ("CCI"); TCG; Worldcom, Inc. ("Worldcom"); Central Telephone Company of Illinois ("Centel"); the Cable Television and Communications Association of Illinois ("CTCA"); the Citizens Utility Board ("CUB"); the People of the State of Illinois ("AG"); MCI; McLeod Telemanagement, Inc.; One Stop Telecommunications; MFS Intelenet of Illinois, Inc. ("MFS"); Sprint Communications Company L.P.; and Telefiber Networks Of Illinois. The City of Chicago ("Chicago") appeared as a party. The Illinois Commerce Commission Staff ("Staff") also appeared.

On October 28, 1996, Ameritech Illinois filed its TELRIC studies with the Commission pursuant to the September 25, 1996 order. In addition, MCI filed the Hatfield Model Version 2.2 Release 2, on this same date. On December 18, 1996, MCI sent a letter withdrawing the Hatfield Model on the basis that updates to the Model would not be available until early January, 1997.

Pursuant to the schedule established by the Hearing Examiner in Docket 96-0486, Ameritech Illinois served its prepared direct testimony in that docket on December 18, 1996. On January 8, 1997, Ameritech Illinois filed a motion to consolidate Docket 96-0569, the suspended UNE tariff docket, with Docket 96-0486. While that motion was pending, Staff and Intervenor in Docket 96-0486 served their prepared direct testimony on February 14, 1997. On March 6, 1997, the Hearing Examiners in Dockets 96-0486 and 96-0569 granted Ameritech Illinois' motion to consolidate. Pursuant to the schedule established by the Hearing Examiners, Staff and Intervenor served additional prepared testimony in the consolidated dockets on March 7, March 31, April 8 and May 2, 1997. Ameritech Illinois served additional prepared testimony on March 31, April 1, April 4 and May 2, 1997.

Pursuant to notice, evidentiary hearings in the consolidated dockets were held before duly authorized Hearing Examiners at the Commission's Chicago offices on May 12-16 and May 19-21, 1997. Testimony on behalf of Ameritech Illinois was filed by Mr.

David Gebhardt, Vice President Regulatory Affairs for Ameritech Illinois; Mr. Thomas O'Brien, Director - State Regulatory Planning and Policy for Ameritech Illinois; Mr. William Palmer, Director of Economic Analysis at Ameritech Corporation; Mr. Daniel Broadhurst, a Partner with Arthur Andersen; Mr. Edward Marsh, Jr., Director of Regulatory Support in Ameritech Corporation's Public Policy Organization; Dr. Debra Aron, a Director of Law and Economics Consulting Group; Mr. Michael Domagala, Financial Planning Analyst for Ameritech Corporation's Treasury Department; Dr. Robert Korajczyk, Professor of Finance at Northwestern University and a Principal of Chicago Partners, an economic litigation support consulting firm; Mr. Paul Quick, Director of Integrated Strategies for Ameritech real estate group; and Ms. Roberta Garland, a consulting actuary affiliated with Arthur Andersen. Testimony on behalf of the Staff was filed by Mr. Douglas Price, Supervisor of the Rates Section in the Telecommunications Division; Ms. Joy Nicdao-Cuyugan, Senior Financial Analyst in the Public Utilities Division; and by Mr. Christopher Graves, Ms. Rasha Toppozada-Yow, Mr. Jason Hendricks, Mr. S. Rick Gasparin, Mr. Samuel Tate, and Mr. Samuel McClerren, Economic Analysts in the Telecommunications Division. Testimony on behalf of AT&T was filed by Mr. James Henson, AT&T's District Manager - State Government Affairs; Mr. James Webber, Senior Consultant with Competitive Strategies Group, Ltd. a consulting firm; Dr. Janusz Ordover, Professor of Economics at New York University; Mr. Bruce Bennett, Assistant Vice President - Government Affairs for AT&T's Central Region; and Mr. Robert Sherry, a principal member of AT&T's Technical Staff. Testimony on behalf of MCI was filed by Dr. August Ankum, a consulting economist; Mr. Michael Starkey, a Principal of Competitive Strategies Group, Ltd.; and Mr. Carl Giesy, Regional Director of Competition Policy for MCI's Northern Region. Testimony was filed jointly on behalf of AT&T and MCI by Dr. Bradford Cornell, Professor of Finance at UCLA and President of FinEcon, a financial economic consulting firm; Mr. Michael Majoros, Vice President of Snaveley, King, Majoros, O'Connor and Lee, Inc., an economic consulting firm; and Mr. Brad Behounek, Senior Consultant with Competitive Strategies Group, Ltd. Testimony on behalf of WorldCom was filed by Mr. Joseph Gillan, a consulting economist. Testimony on behalf of Consolidated was filed by Mr. Edward Pence, a Senior Manager for Consolidated. Testimony on behalf of TCG was filed by Mr. William Montgomery a Principal of Montgomery Consulting. At the close of the hearing on May 21, 1997, the record was marked "Heard and Taken."

In our First Interim Order the tariffs filed in Docket 96-0569 were cancelled by agreement of the parties while we continued our consideration of the issues in this consolidated docket. On June 11, 1997, Staff, Ameritech Illinois, TCG, Worldcom and CCI filed initial post-hearing briefs, and AT&T/MCI filed a joint initial post-hearing brief. On June 25, 1997, Staff, Ameritech Illinois, AT&T/MCI, TCG, Worldcom and CCI filed reply briefs and/or draft orders. On August 8, 1997, the Hearing Examiner issued a Proposed Second Interim Order. Ameritech Illinois, AT&T/MCI, CCI, WorldCom, TCG and Staff filed Briefs on Exceptions, and the same parties with the exception of TCG filed Reply Briefs on Exceptions. The Commission has considered the exceptions and replies and appropriate changes have been made to the Proposed Order.

Before turning to our discussion of the contested issues and the evidence in these consolidated dockets and our analysis and conclusions based on that evidence, we note that the products and services addressed in this proceeding are subject to federal law – namely the Act – and that the Act addresses, among other things, the establishment of rates, terms and conditions for those products and services. As a result, our findings and conclusions are necessarily informed and circumscribed by the Act. In particular, the prices for interconnection, UNEs and local transport and termination that we establish here, to be subsequently incorporated into interconnection agreements or tariffs, are governed by and must comply with Sections 252(d)(1) and 252(d)(2) of the Act. Those Sections provide as follows:

(d) PRICING STANDARDS.—

(1) INTERCONNECTION AND NETWORK ELEMENT CHARGES.— Determinations by a State commission of the just and reasonable rate for the interconnection of facilities and equipment for purposes of subsection (c)(2) of section 251, and the just and reasonable rate for network elements for purposes of subsection (c)(3) of such section –

(A) shall be –

(i) based on the cost (determined without reference to a rate of return or other rate-based proceeding) of providing the interconnection or network element (whichever is applicable), and

(ii) nondiscriminatory, and

(B) may include a reasonable profit.

(2) CHARGES FOR TRANSPORT AND TERMINATION OF TRAFFIC.—

(A) IN GENERAL.— For the purposes of compliance by an incumbent local exchange carrier with section 251(b)(5), a State commission shall not consider the terms and conditions for reciprocal compensation to be just and reasonable unless—

(i) such terms and conditions provide for the mutual and reciprocal recovery by each carrier of costs associated with the transport and termination on each carrier's network facilities of calls that originate on the network facilities of the other carrier; and

(ii) such terms and conditions determine such costs on the basis of a reasonable approximation of the additional costs of terminating such calls.

(B) RULES OF CONSTRUCTION.— This paragraph shall not be construed—

- (i) to preclude arrangements that afford the mutual recovery of costs through the offsetting of reciprocal obligations, including arrangements that waive mutual recovery (such as bill-and-keep arrangements); or
- (ii) to authorize the Commission or any State commission to engage in any rate regulation proceeding to establish with particularity the additional costs of transporting or terminating calls, or to require carriers to maintain records with respect to the additional costs of such calls.

We also note that the August 8, 1996 Regulations promulgated by the FCC and accompanied by the FCC Order implement the provisions of Sections 251 and 252 and further address the prices, terms and conditions which the FCC intended to be applicable to Ameritech Illinois' provision of interconnection, UNEs and local transport and termination. On October 15, 1996, the U.S. Appellate Court, Eighth Circuit issued a stay of certain of these regulations pending further review Iowa Utilities Board v. FCC, 109 F.3d 418 (8th Cir.), motion to vacate stay denied, 117 S. Ct. 429 (1996). Ameritech Illinois maintains that it complied with all of the pricing-relating provisions of the FCC Regulations and the related guidance set forth in the FCC Order in conducting its cost studies and developing the proposed prices that it presented in these consolidated dockets. Staff and Intervenors also relied on the FCC pricing regulations to a substantial extent as touchstones for their respective positions in these dockets. On July 18, 1997, the Appellate Court entered its opinion vacating the following provisions of the FCC pricing regulations: 47 C.F.R. §§ 51.303, 51.305(a)(4), 51.311(c), 51.315(c)-(f), 51.317 (in part), 51.405, 51.505-51.515 except for 51.515 (b), 51.601-51.611, 51.701-51.717 (with some exceptions) and 51.809. The general basis for the Appellate Court's decision was that the FCC had exceeded its jurisdiction and authority under the Act by establishing regulations governing the pricing of intrastate telecommunications services. The Court held that the Act reserved these matters to the states. Although the vacated FCC pricing regulations are not binding upon us, we believe that they provide useful guidance in reaching our own conclusions concerning the proper application of Sections 251 and 252.

II. CONTESTED ISSUES

A. *Relationship Between Wholesale and UNE Rates*

Position of Ameritech Illinois

In its testimony in this proceeding, Ameritech Illinois expresses its concern that the availability of end-to-end network element bundling at rate levels that are inconsistent with those established for wholesale services would encourage rate arbitrage by new entrants. (AI Ex. 6.0 at 27-28 and AI Ex. 1.0 at 23-24). To alleviate this concern, the Company recommends that the Commission be mindful of the potential for arbitrage when determining the prices of UNEs. (AI Ex. 6.0 at 31). AI adds

that "the pricing of unbundled network elements must be rationalized relative to the prices for the corresponding resold services" and that the "[p]rices for unbundled network elements should be equal to or higher than the comparable prices for resold service." (AI Ex. 1.0 at 24).

In defense of its recommendation, Ameritech Illinois states that there is no difference in the risk incurred by the purchaser of end-to-end UNEs and the purchaser of wholesale services. It claims that an end-to-end network element purchaser will benefit from lower prices at the expense of Ameritech Illinois and its shareowners. As a result, good public policy requires the rationalization of the pricing of network elements with the pricing of wholesale prices to avoid such an unwarranted result. (AI Ex. 1.1 at 14-15).

Finally, Ameritech Illinois states that its recommended UNE pricing approach accomplishes the objective of setting wholesale rates as a price floor for UNE rates, while still adhering to the different pricing standards in the federal Act. (Id. at 15-16).

Position of AT&T

AT&T disagrees with Ameritech Illinois' proposal to mandate a pricing relationship between wholesale services and UNEs for several reasons. AT&T witness Ordoover points out that Ameritech has failed to establish that the cost of end-to-end network element bundling will be uniformly less expensive than the price of resold services. (AT&T Ex. 3.0 at 36). Dr. Ordoover adds that if some new entrants purchase end-to-end network elements and replicate the incumbent LEC's current offerings, if the prices charged by these new entrants are lower than the incumbent's retail rates, that will force the incumbent LEC to reduce its retail rates, thereby reducing its wholesale rates. He finds this to be a positive outcome of competition. (AT&T Ex. 3.0 at 36-37).

Position of Staff

Staff opposes Ameritech Illinois' proposal for the establishment of a mandated pricing relationship between wholesale rates and UNEs rates. Staff maintains that there is a significant difference in the level of both benefit and risk incurred by a new entrant when choosing to offer local service through UNEs compared to resale. There are also significant differences in the levels of benefit and risk incurred by the incumbent LEC. These differences in benefits and risks make it difficult to conclude how UNE rates should compare with wholesale rates or that it is appropriate to utilize wholesale rates as a price floor for UNEs. (Staff Ex. 3.00 at 12-13). Staff cites discussion in the FCC Order in support of these assertions.

Staff also questions the feasibility of Ameritech Illinois' proposal. For example, if the Company's intention to price the sum of all UNEs equal to or greater than the sum of its wholesale rates were adopted, then how would the rate of the individual UNEs be determined? Should they be determined based on their individual costs to attempt to

remain consistent with section 252(d)(1) (if that is possible)? If so, then what should one do if the sum of UNE rates based on costs is less than the sum of wholesale rates? (Staff Ex. 3.00 at 13-14).

Staff notes that the pricing standards established in the federal Act for wholesale services are distinctly different from those established for UNEs. Section 252(d)(3) requires that wholesale rates be set based on retail rates less avoidable costs. However, rates for interconnection and UNEs must be based on cost pursuant to section 252(d)(1). An attempt to equate the rates for UNEs with those for wholesale services would render section 252(d)(1) meaningless, because it would, in effect, base the sum of UNE rates on total Ameritech Illinois retail rates for local services less avoidable cost. (*Id.* at 14-15). If the sum of UNEs rates were set equal to the sum of wholesale rates, how would rates for "interconnection" be set? Interconnection is subject to the same pricing requirements as UNEs (section 252(d)(1)). (*Id.* at 15). Staff claims that it never received satisfactory answers to these questions from the Company.

Commission Analysis and Conclusion

The Commission rejects Ameritech Illinois' proposal that there be a mandated pricing relationship between wholesale rates and UNEs. As Staff has noted, the pricing standards under the Act are distinctly different. These reflect Congress' intention to establish two means by which local exchange competition could be facilitated. We also agree with Staff that the benefits and risks of the two methods of market participation also are different.

Pursuant to Section 252(d)(3), wholesale rates are based on retail rates less avoided costs, essentially a top down approach. Section 252(d)(1) establishes "cost" as the basis for pricing UNEs and interconnection - a bottom up approach. There is no readily ascertainable relationship between the "avoided costs" of Section 252(d)(3) and the "costs" identified in Section 252(d)(1) such that any difference between prices based upon the two standards need to be "rationalized." There is certainly nothing to indicate that Congress intended the states to ensure that the incumbent local exchange carrier ("LEC") receive "at least the same revenues whether a competitor chooses to serve a customer by purchasing wholesale services or unbundled network elements." (AI Ex. 1.1 at 15).

B. Cost Study Assumptions

1. Cost of Capital.

Five witnesses presented testimony regarding the appropriate cost of capital component to be incorporated in the TELRIC analysis of the Company's cost of providing interconnection and unbundled network elements. Three witnesses, Ameritech Illinois witness Domagola, ATT/MCI witness Cornell and Staff witness Nicdao-Cuyugan, undertook independent cost of capital analyses to develop an overall cost of capital recommendation. Based on his analysis Mr. Domagola estimated the cost of capital to be in the range of 10.6% to 14.0%. From this range, the Company witness Palmer selected a weighted average cost of capital ("WACC") of 11.5% to be used in its cost studies. Dr. Cornell, as a result of his studies, determined the WACC is to be in the range of 9.12% to 10.36% with a midpoint of 9.74%. Ms. Nicdao-Cuyugan concluded the appropriate cost of capital to be 9.52%. Company witness Korajczyk supported Mr. Domagola's methodology. TCG witness Montgomery identified certain perceived deficiencies in Ameritech Illinois' analysis and proposed several corrections. We turn now to the specific disputed issues.

a. Capital Structure

Position of Ameritech Illinois

Ameritech Illinois witnesses Domagola and Korajczyk recommend using the average June 30, 1996 market value capital structure of twelve telecommunications companies as the Company's capital structure. Mr. Domagola calculated the debt to market equity ratios for each company in his sample group and took an average of these ratios, including Ameritech, Inc., to arrive at a debt ratio of 25.3% and a resulting market equity ratio of 74.7%. (AI Ex. 7 at 14-15).

Dr. Korajczyk testified to the theoretical validity of the use of market-based ratios in determining an appropriate cost of capital for a firm and that such views are advocated by the best texts on corporate finance whether written by academics or practitioners. He explained that use of book value weights for the equity and debt components of the capital structure will underestimate the cost of capital and induce logical inconsistencies in the way a firm's cost of capital is calculated. He also warned that regulation which imposes a price structure assuming an artificially low cost of capital will lead to underinvestment in that service by competitors.

The Company argued that under traditional rate of return regulation, where the utility held a secure monopoly position and protection from competition and the rigors of the marketplace, the use of book values for regulatory purposes was less problematic, but it would be entirely inappropriate to continue a regulatory approach which would systematically understate the cost of capital in an environment characterized by competition and deregulation. Ameritech Illinois claims that to do so

would place it at an unfair competitive disadvantage and inappropriately disenchant competitors from making facilities-based investments. In addition, it would also be contrary to the cost standards contained in the Act and the FCC Order.

In response, Staff argued that since Ameritech Illinois is not market traded, it has no market value capital structure. Unlike the cost of equity, which can be estimated by using a sample of firms comparable in risk, a firm's capital structure (market value or book value) cannot be estimated by using a comparable sample. Companies comparable in risk can, and do, have significantly different capital structures. Second, Mr. Domagola failed to establish how the market value capital structure of the telecommunications firms in his sample, two of which derive most of their revenues from non-telephone businesses (Alltel and Cincinnati Bell), would be reflective of Ameritech Illinois' marginal capital structure. Third, despite his claims that his proposed capital structure is consistent with Ameritech Illinois' objective of maintaining a capital structure that supports its overall business strategy and allows it to sustain appropriate levels of investment in the business while preserving a debt rating that maximizes financial flexibility (AI Ex. 7.1, at 4-5); he failed to demonstrate why his stated capital structure objective is reasonable, nor did he demonstrate why a capital structure with 74.7% common equity is necessary for Ameritech Illinois to meet such an objective.

Position of AT&T/MCI

Since the entity under study is a subsidiary of a holding company and where, as here, that subsidiary has no pure play comparable companies which are publicly traded, Dr. Cornell used the Ameritech Corporation consolidated capital structure as the starting point for his analysis. (AT&T/MCI Joint Ex. 4.0, at 30-31). In this case, however, Dr. Cornell believed it appropriate to temper the use of market weights because he views the network element leasing business as being a virtual monopoly subject to little competition. He averaged the Ameritech capital component weights with the weights of his group of comparable companies to produce what he regarded as a representative capital structure for purposes of the WACC analysis. (AT&T/MCI Joint Ex. 4.0, Attachments BC-2 and BC-10). He also presented the capital structure based on both book value and market value weightings and, after assigning the component costs he deemed appropriate, averaged the result derived, based on the average book value structure (including short-term debt) – 43 percent equity/57 percent debt, – with the results derived based on the average market value structure (including short-term debt) – 75 percent equity/25 percent debt – to produce his final cost of capital recommendation. (AT&T/MCI Joint Ex. 4.0, at 30-32 and Attachment BC-10). Dr. Cornell also provided Ameritech-specific book and market capital structures including short-term debt of 51 percent equity/49 percent debt and 82 percent equity/18 percent debt, respectively. (*Id.*, at 31-33 and Attachment BC-9). However, he noted that the use of these structures, while producing slightly higher estimates of the cost of capital, would not increase his recommendation significantly. (*Id.*, at 33). Effectively, Dr. Cornell recommended using a capital structure that consists of 41% long-term debt and 59% common equity.

Ameritech Illinois responded that Dr. Cornell's view of UNEs as monopoly services was wrong. It claimed that Dr. Cornell had no basis for his opinion as to the state of competition or monopoly nature of UNEs in Illinois because he had done no study of that issue and was ignorant of the most fundamental information concerning that issue in this state. The Company pointed out that there are at least four facilities-based companies currently providing local exchange service in Chicago and downstate, and at least 24 facilities-based certificated LECs. In addition Ameritech Illinois believes it will face significant competition from cable television and AT&T's wireless technology.

Staff asserted that the ATT/MCI approach suffered from the same deficiency as the Company's because it used a comparable firms analysis for determining capital structure.

Position of Staff

Staff witness Nicdao-Cuyugan recommended using the Company's average actual capital structure for the year ending September 30, 1996. Her recommended capital structure consists of 23.3% short-term debt, 35.5% long-term debt and 41.2% common equity. She testified that the appropriate capital structure for this proceeding would reflect the proportion of capital that Ameritech Illinois would raise on the margin to finance new investment. (Staff Ex. 4 at 4-5). However, she noted that determining a marginal capital structure with certainty is difficult because it requires a forecast of how a firm will finance future investment. A firm's target capital structure is useful in determining a firm's marginal capital structure since it is reasonable to assume that a firm will raise new capital in proportions consistent with achieving its target capital structure. Since Ameritech Illinois did not identify a target capital structure, Ms. Nicdao-Cuyugan examined recent trends in its capital structure. That examination indicated Ameritech Illinois' actual capital structure has not changed significantly since it discontinued following FASB 71 in 1994. In addition, the Company has not indicated any intention to alter significantly its actual capital structure. To maintain its current capital structure, Ms. Nicdao-Cuyugan testified that it would need to raise capital to finance future investment in proportions consistent with its actual book value capital structure. Since new capital is recorded at market value on a company's books, the book value of new capital equals its market value. As a result, the market value of Ameritech Illinois' marginal capital structure would have proportions similar to its actual book value capital structure. Thus, Staff asserts that the marginal capital structure proposed by its witness for Ameritech Illinois is no more a book value capital structure than it is a market value capital structure. (Staff Ex. 4.02 at 2-4).

Ameritech Illinois responded that a "marginal" capital structure is not a standard that appears in the Act or the FCC Order. In fact, the FCC rejected the "marginal" increment as the appropriate increment upon which to focus for TELRIC purposes in its discussion of services for TSLRIC and TELRIC purposes. In addition, Ameritech Illinois

responded that regardless of whether Staff refers to its proposed capital structure as a "marginal" or "actual" capital structure, it nonetheless represents a capital structure inappropriately based exclusively on book equity ratios.

Ameritech Illinois also maintains that Staff's recommended capital structure reflects the full effects of the huge writedown of assets of approximately \$1.2 billion which occurred in 1994 as a result of the discontinuance of FASB 71 due to the inability of regulators to assure recovery of investments in the increasingly competitive telecommunications market. It also argues that Staff's attempt to establish a target capital structure through the use of book based ratios is contrary to the authoritative sources which Staff cites in support of its position.

Commission Analysis and Conclusion

The Commission will utilize Staff's recommended capital structure. As Staff cogently stated, the capital structure issue presented is: "In what proportions will Ameritech Illinois issue new capital if it were to finance new investment?" Contrary to the Company's arguments, we consider Ms. Nicdao-Cuyugan's approach to be conceptually sound. Staff's proposed calculation of the marginal cost of capital equals the incremental cost of capital which is the theoretically correct approach to determine a forward-looking cost of capital.

Having concluded that Staff's theoretical basis for determining the appropriate capital structure is acceptable, the next question is what are the appropriate debt and equity proportions? Although target market weights ideally should be used to determine the proportions of a forward-looking capital structure, Ameritech Illinois did not identify any target market weights; and since its common stock is not publicly traded, an actual market weight cannot be determined. Therefore Staff reasonably concluded, and the evidence of record indicates, that the Company will continue to issue new capital in proportions similar to the proportions of its actual book value capital structure. It was shown that Ameritech Illinois has not significantly deviated from those proportions in the recent past nor has it indicated it will deviate from those proportions in the future. In effect, Staff's approach assumes that an UNE business would be financed with such a market capital structure if it were a stand-alone company. We find that to be a reasonable assumption.

Furthermore, most of the Company's objections are based on a serious misconception regarding Staff's proposal. As Staff pointed out, its proposed capital structure is not really a book value capital structure because capital raised to finance new investment is recorded at market value on the company's books, therefore, the book value of new capital equals its market value. The debt and equity proportions of the market value of new capital have the same proportions as the book value of new capital. More importantly, Staff used book values as a proxy for future capital structure because, as indicated above, it was impossible to determine a forward-looking capital structure in the manner suggested by financial theory. Staff is not using book values as

a substitute for a forward looking capital structure, it is using book values as a means to determine one.

Ameritech Illinois did not persuasively demonstrate a meaningful relationship between the capital structures of the firms in its sample group and its own forward-looking cost of capital. Quite apart from the inappropriate use of the firms to which Staff objected, companies which are comparable in risk often have significantly different capital structures. While we will not go so far as to say that a sample group never can be used to establish an appropriate capital structure for a firm, that type of data must be interpreted with care.

We have additional confidence that Ameritech Illinois' current book ratios are an accurate and suitable indicator of its future capital structure because in Docket 92-0448 after an extensive review, we rejected allegations that its capital structure was being manipulated by its parent corporation. Correspondingly, if the Company's proposed capital structure genuinely reflects the proportions in which new capital will be raised, then one would expect some corroboration either in the trend of book ratios or in the planning documents of the Company. For example, an anticipated increase in the equity ratio would be demonstrated by Ameritech Illinois plans to issue new stock, retire debt early or reduce its payout ratio. To the contrary, the evidence shows that there has been no significant change in Ameritech Illinois' capital structure since 1994, and no evidence of any plans to make significant changes in its capital finance policies. Also, it provided no evidence supporting Mr. Domagola's assertion that a 74.7% common equity ratio - a level which we believe is unprecedented in Commission telecommunications proceedings - is necessary to support Ameritech Illinois' unbundling and interconnection activities. Finally, even if we agreed with its assessment of current and future competition in the UNE and interconnection services markets, which we do not, the Company has not explained how and why this would translate into such a drastic departure from its current capital finance policies.

b Cost of Equity

Position of Ameritech Illinois

To arrive at an appropriate range for the cost of equity, Mr. Domagola utilized both a DCF and a CAPM analysis, but indicated that his preferred methodology is the CAPM analysis, which is utilized in estimating the cost of capital for internal corporate purposes. In his analyses, he utilized a peer group of 12 telecommunication companies, which included Ameritech Inc., as a proxy for Ameritech Illinois. (AI Ex. 7 at Schedules 2, 6 and 8). Mr. Domagola first employed a single-stage DCF model which assumes that long-term earnings growth will continue at present projected levels into the future. This analysis employed a quarterly DCF model, closing stock prices as of October 10, 1996, and Institutional Brokers Estimate System ("IBES") and Zacks Investment Research ("Zacks") five-year earnings per share growth rates. (AI Ex. at 7-10). To illustrate the result when reducing growth rate estimates, Mr. Domagola also

employed a two-stage DCF model. He developed this model by averaging the peer group samples (including Ameritech) low-end growth rates as reported by Zacks and IBES. (*Ibid.* at 10-12). Mr. Domagola also performed a Capital Asset Pricing Model ("CAPM") analysis that utilized three-year data periods obtained from IBES and two year data periods derived from Bloomberg Financial Markets database ("Bloomberg"), a six-month average of a 20-year U.S. Treasury Bond (7.11%) as the risk-free rate, and the average excess return over long-term government bond income returns from 1926 to 1995 (7.4%), as his market risk premium. (AI Ex. 7 at 4-6; AI Ex. 7.1 at 10, corrected). In his direct testimony, Mr. Domagola recommended a cost of common equity range of 11.8% to 16.36%, with a midpoint of 14.08%. This was based on a cost of equity range of 11.5% (DCF result for peer group) to 15.9% (CAPM result for Ameritech, Inc.). (AI Ex. 7 at 13-14). He adjusted both his CAPM and DCF analyses to reflect flotation costs. Citing studies that indicate that flotation costs for utilities appear to be in excess of 4% and less than 5%, Mr. Domagola utilized a formula developed by Arzac and Marcus for calculating how the cost of equity should be adjusted to prevent future flotation costs from diluting returns to current shareholders. These adjustments added approximately 40 basis points to his estimated CAPM and DCF cost of equity analyses. Although Mr. Domagola revised his CAPM results upward in his rebuttal testimony, he did not revise his recommended cost of common equity range. (*Ibid.* at 10).

Dr. Cornell maintains that it is inappropriate for Ameritech to use the single-stage DCF model to establish the bounds of a cost of capital range because the five-year forecasts on which the model is designed assume a double-digit growth rate. (AT&T/MCI Joint Ex. 4.0, at 38). By extension, assuming a perpetual growth rate in excess of the growth rate of the overall economy implies that Ameritech will grow to become the entire economy over time, which is clearly an impossibility. Use of the single-stage DCF model in conjunction with a multi-stage model, Dr. Cornell observes, also reflects an inaccurately broad range of possible DCF equity costs which is biased on the high side. *Id.*

Dr. Cornell further asserts that the 1.25 beta risk premium that the Company used in its CAPM analysis is overstated. (*Id.*, at 38-39). As support for this contention, he points to alternative beta sources not relied on by Ameritech such as Value Line (0.85) and Dow Jones Beta Analytic (0.92). The Company's beta factor also implies that it is much riskier than the overall S&P 500, a conclusion that is not supportable. Dr. Cornell points out that Ameritech's 1.25 beta is substantially above the beta calculated by Mr. Domagola for the peer group. (AT&T Cross Ex. 23). Thus, Ameritech's beta estimate does not accurately measure its true systematic risk.

Dr. Cornell next criticizes Ameritech's reliance on the Ibbotson Associates data from 1926 as the sole source to estimate the forward-looking equity risk premium without considering other important sources such as Siegel and Blanchard, who indicate that the forward-looking equity risk premium could be as low as 2 to 3 percent. (AT&T/MCI Joint Ex. 4.0, at 25-27, 39-40). Dr. Cornell disagrees that the flotation

adjustment is necessary because Ameritech is a large Fortune 500 company whose stock trades in an efficient market, and accounts for future events such as financing costs. (*Id.*, at 40-42). Adding a flotation device, therefore, results in double recovery of the cost of financing. Ameritech has not issued common stock over the past five years, nor is there any reason to expect large equity financing in the foreseeable future.

Staff criticized Mr. Domagola's CAPM result on the basis that it placed undue reliance on a single company's cost of equity (Ameritech) to develop the high end of the range. Ms. Nicdao-Cuyugan testified that because cost of equity models necessarily rely on proxies for input data, an individual cost of equity estimate is subject to measurement error. However, measurement error can be mitigated by the use of a sample. (Staff Ex. 4 at 26-27). Although Mr. Domagola estimated the peer group sample's CAPM cost of equity, he did not use that estimate to develop either the high-end or low-end of his recommended cost of common equity range. (Staff Ex. 4.2 at 5-6). Staff also criticized the peer group sample because it contained firms where more than half of the revenues are derived from non-telephone businesses and because it contained companies that were undergoing merger activity (NYNEX, Bell Atlantic, Pactel and SBC Communications). Because currently available market data on merging companies reflect the market's expectations of post-merger utility operations, the measured cost of equity estimate would be internally inconsistent. For example, the merging companies' stock price and growth rates used by Mr. Domagola for his DCF analysis would reflect investor expectations of risk and return from the expected merged local exchange operations. However, the dividend input into his DCF model (i.e., the current dividend to which the growth rate estimate is applied) reflects pre-merger operations. (Staff Ex. 4 at 27).

Staff also objected to Mr. Domagola's constant growth DCF analysis, alleging that the deficiencies in his peer group sample renders that analysis inappropriate. Staff indicated that if the companies to which it objects are excluded from the peer group sample, the result would yield a constant growth DCF equity range of 13.10% to 13.63%. With regard to beta, Staff maintained that Mr. Domagola's use of Ameritech's CAPM cost of capital to develop the high end of his common equity range placed undue weight on Ameritech's beta. Staff also objected to the use of betas from companies in the peer group sample to which it objected and further claimed that use of two-year betas from Bloomberg overestimates the cost of equity. Staff also claimed that Mr. Domagola's analysis yields negative alpha intercepts and that Staff's use of the current yield implied by the price of T-Bill futures contracts to determine the risk free rate was preferable to Mr. Domagola's use of average 6-month spot yields on treasury bonds. Staff also criticized Mr. Domagola's use of a non-constant growth DCF model (albeit with two growth stages as opposed to Dr. Cornell's three growth stages). Staff's objection to this approach is discussed below in its response to Dr. Cornell's testimony.

The Company responded to these criticisms. With regard to Staff's claim of undue reliance on Ameritech's beta measures to arrive at the cost of equity estimate of 15.9%, Mr. Domagola noted that he also performed a second estimate utilizing the peer

group average which yielded a cost of equity of 13.7%. He indicated that including Ameritech in the sample group average results in an average beta of .97 and a resulting cost of equity of 13.9%, while using Dr. Cornell's approach of calculating a weighted average between the peer group results and the Ameritech results would yield a cost of equity of 14.3%. Mr. Domagola did not believe that these results, taken together, differed materially from the 14.8% midpoint of his CAPM results in terms of supporting the 11.5% WACC that Mr. Palmer utilized. He also disagreed that the objections Staff cites to the inclusion of certain companies in his peer group sample are sufficient to exclude them from that group. Ameritech Illinois also noted that, according to Staff, eliminating all the companies to which Staff objects from the peer group sample would yield a constant growth DCF analysis cost of equity range of 13.10% to 13.63%. Utilizing these costs of equity in Mr. Domagola's WACC calculation still would yield a range for the WACC (11.56% to 11.93%) which exceeds the 11.50% WACC selected by Mr. Palmer. Mr. Domagola also indicated that use of two-year betas from Bloomberg is more appropriate in the rapidly changing telecommunications industry. He indicated that the use of longer historical time frames would incorporate data derived from periods when Ameritech Illinois still enjoyed a protected monopoly franchise and operated under traditional rate of return regulation. Such is not the case today and obviously will not be the case on a forward-looking basis.

Position of Staff

Ms. Nicdao-Cuyugan used the constant growth DCF and CAPM models to estimate Ameritech Illinois' cost of common equity. She applied these models to a sample of eight telephone companies from the S&P's Telecommunications Compustat database. The companies were selected on the basis of availability of market data needed to perform the specified cost of equity analyses. Telephone companies that were in the process of merging were excluded since their market data would not be reflective of the operations of the existing company. To ensure the sample's similarity to Ameritech Illinois' primary business, companies that generate the majority of their revenues from non-telephone operations were excluded from the telephone sample. (Staff Ex. 4.0 at 7). In performing her constant growth DCF analysis, she used a quarterly model, each firm's most current stock price, and forward-looking earnings per share growth rates published by IBES and Zacks. The telephone sample's resulting adjusted DCF cost of equity estimate ranges from 13.30% to 13.87%. (Staff Ex. 4 at 22-23). Ms. Nicdao-Cuyugan also presented a CAPM analysis utilizing the risk-free rate of return implied by the prices of T-Bill and T-Bond futures contracts. She testified that under current market conditions, the T-Bill yields currently provide a more reasonable estimate of the true risk-free rate while T-Bills yield yields overstate the true risk-free rate. (Staff Ex. 4.0 at 13-17). Her market return of 14.47% was determined by conducting a constant growth DCF analysis for the individual firms that compose the S&P composite index. Ms. Nicdao Cuyugan used Merrill Lynch's beta calculation method to derive beta estimates for each firm in her sample. The average calculated beta estimate for the telephone sample Ms. Nicdao-Cuyugan used in her CAPM analysis is 0.85. (Staff Ex. 4 at 12-21). She formed her recommended cost of common

equity range of 12.90% to 13.90% with a midpoint estimate of 13.40% by: a) rounding the telephone sample CAPM cost of equity estimate based on the T-Bill yield (13.17%) to the nearest ten basis points, or 13.20%; b) rounding the midpoint of the telephone sample DCF-derived estimates of the cost of common equity (13.59%) to the nearest 10 basis points, or 13.60%; and c) expanding the resulting range, 13.20% - 13.60%, by 60 basis points to recognize the imprecision inherent in estimates of the cost of common equity. (Staff Ex. 4 at 23-25). Ms. Nicdao-Cuyugan did not recommend a flotation cost adjustment.

Ameritech Illinois disagreed with the Staff criticisms of Mr. Domagola's cost of equity analysis. Nonetheless, it noted that the methodologies Staff utilized to determine an appropriate cost of equity were not necessarily unreasonable, and that they did not yield results which were unreasonable for purposes of determining a WACC in these proceedings. The Company argued that, if applied to an appropriately market-based capital structure, Staff's cost of equity yields a WACC of 12.11%, which supports Mr. Palmer's use of an 11.50% WACC in the TELRIC studies (based upon the average of the December 31, 1995 and September 30, 1996 market value capital structure for Ameritech consisting of 19.5% debt and 80.5% equity).

Position of AT&T/MCI

AT&T/MCI witness Dr. Cornell also performed both a DCF and a CAPM analysis to arrive at his recommended cost of equity. (AT&T/MCI Joint Ex. 4.0 at 16 and 22). He used a group of 11 telecommunication companies, including Ameritech Corporation, to estimate Ameritech Illinois' cost of common equity. He performed a non-constant growth DCF analysis which employed an annual model, stock prices as of July 31, 1996, IBES five-year earnings per share growth estimates for the first growth stage and a 5.61% average estimate of long-term GNP growth for the last growth stage. (AT&T/MCI Joint Ex. 4.0 at 13-17 and Attachment BC-4). To develop his 11.21% DCF cost of common equity estimate, Dr. Cornell gave 75% weight to the average DCF estimate of his 10-company peer group sample and 25% weight to Ameritech's DCF estimate. He gave greater weight to Ameritech in this analysis because he believed that it was the best source for determining the Company's cost of capital.

Dr. Cornell's CAPM analysis utilized: the average beta of his ten-company sample and Ameritech, Inc. (re-levered using Ameritech's capital structure), or .80; the yield on a 20-year T-Bond, or 7.1%, and a time-horizon adjusted T-Bond yield, or 5.4% (T-Bond yield minus-time horizon premium of T-Bonds). Dr. Cornell developed his market-risk premium estimates by applying his judgment to various historical and forward-looking market-risk premiums he calculated. (AT&T/MCI Joint Exhibit 4.0 at 20-29; AT&T/MCI Joint Exhibit 4.1 at 17-18) His CAPM analysis resulted in a range of 11.4 % to 11.5 % with a 11.45% midpoint. Based on his analysis, Dr. Cornell concluded that Ameritech Illinois' cost of common equity ranges from 11.21% (DCF) to 11.45% (CAPM midpoint) with a midpoint estimate of 11.33%. (AT&T/MCI Joint Ex. 4.0 at 29). He did not recommend a flotation cost adjustment.